YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 June 2023

Yarra Emerging Leaders Fund

Gross returns as at 30 June 2023

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Emerging Leaders Fund	0.71	4.37	20.21	12.08	8.32	11.81	11.12
Emerging Leaders Combined Benchmark†	0.55	2.01	13.18	9.19	5.46	9.64	6.98
Excess return (before fees)‡	0.16	2.37	7.04	2.90	2.86	2.17	4.14

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are gross of all management costs, meaning they do not reflect the deduction of any investment management fees and expenses which would reduce returns and assume reinvestment of all distributions. Investment in the fund is not available on a fee free basis and this should be factored into any analysis of past performance.

Net returns as at 30 June 2023

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Emerging Leaders Fund	0.61	4.05	18.73	10.70	6.98	10.43	9.82
Emerging Leaders Combined Benchmark†	0.55	2.01	13.18	9.19	5.46	9.64	6.98
Excess return (after fees)‡	0.06	2.04	5.55	1.51	1.52	0.79	2.84

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* Inception date Yarra Emerging Leaders Fund: September 1997
† Comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

The Emerging Leaders Benchmark gained 2.0% for the quarter, taking its 12-month return to +13.2%. By comparison, the broader S&P/ASX 300 Accumulation Index returned +1.0% for the quarter and, globally, the MSCI World Index climbed by +7.0% for the period.

Utilities (+34.3%) was the top-performing sector, primarily explained by AGL Energy (AGL, +34.3%) following a positive earnings update which was driven by supportive wholesale energy markets.

Information Technology (+11.8%) was a large contributor to the index positive return with Wisetech Global (WTC, +22.5%) and NEXTDC (NXT, +21.4%) rallying strongly over the quarter. Performance from data centre operator NXT reflected strong customer growth and the market's growing conviction in Artificial Intelligence (AI) applications as a source of future demand growth.

Conversely, the weakest performing sector was Consumer Staples (-5.2%). Within the Food Products subsector, a2 Milk (A2M, -15.8%) underperformed during the period on the back of its FY23 guidance update in April and management changes in May in an attempt to accelerate profitability in its US and NZ businesses.

Similarly, Consumer Discretionary (-4.9%) was another lagging sector, with IDP Education (IEL, -19.1%) the main stock contributor to the sector's weak performance following the Canadian government's decision to widen its Student Direct Scheme access to rivals. Underperformance from several retailers such as Premier Investments (PMV, -19.8%) and Lovisa (LOV, -20.4%) further pressured the sector's return.

Portfolio review

Key Contributors

NEXTDC (NXT, overweight) – following the announcement of the data centre operator's largest ever individual contract in April and subsequent regional expansion into Malaysia and New Zealand, NXT continued to outperform as the market's conviction in Artificial Intelligence (AI) applications as a driver of demand growth grew. Most notably, global leading specialist chip maker Nvidia's commentary around AI driven demand growth supported previous comments made by NXT management.

Pinnacle Investment Management (PNI, overweight) – the fund manager outperformed during the period, in part supported by stronger than expected inflows of +$1.9bn during the first three months of 2023. Going forward, we believe revenue growth will accelerate with material longer term growth potential as market conditions normalises from depressed levels, inflows re-accelerate across its diverse range of investment products and via international distribution, performance fees increase from near zero at the 1H23 result and new products mature. Furthermore, margin expansion will be supported by the fixed cost nature of funds management businesses and new manager formation both organically and via acquisitions, which we expect will create additional shareholder value.

Megaport (MP1, overweight) – the global software defined network provider outperformed during the period after reporting a stronger-than-expected March quarterly result. The result was ahead of expectations, with forward guidance for FY24 materially ahead of consensus at both revenue and margin levels, leading to material earnings upgrades and an improved balance sheet position. We continue to hold the position as we believe volume trends will improve in the medium to long term as execution improves and macroeconomic headwinds moderate. Furthermore, we highlight that yield growth, low customer churn, margin expansion (including cost reduction programs) and lower capex will support a transition to free cashflow positive in CY24 and with significant cashflow potential longer term.

Kelsian (KLS, overweight) – the transport services operator outperformed during the period after completing the acquisition of US bus business All Aboard and successfully being granted a number of bus tenders in Sydney. We have a positive view across the three divisions of Australian buses, US buses and Australian tourism. We expect the Australian bus business will return to earnings growth going forward given the defensive nature of its existing contacts with cost pass through, extra charter work, new government contracts in Sydney and improved staff availability. The US bus business has a strong demand outlook from new and existing customers, with pricing increases to offset cost inflation. Finally, the Australian tourism assets will benefit from the post COVID-19 recovery across both international and domestic visitors with a number of years of pent-up demand.

Reliance Worldwide (RWC, overweight) – the manufacturer and distributor of plumbing and heating parts outperformed over the June quarter following the release of the company's March-quarter trading update in late April, coupled with supportive updates from trade distribution peers in the USA. These trading updates have been broadly positive, demonstrating the resilience of RWC's repair-focused end markets (total sales growth of +14.2% for the nine months ending March 2023) and robust margin outlook supported by a cost-out plan and easing raw material cost pressures. We regard RWC as a compelling opportunity, with the market pricing for a significant decline in earnings (P/E of only 14.2 times vs 17.0 times mid cycle) whereas we remain constructive on the demand environment given the defensive nature of RWC's revenue base, the majority of which relates to non-discretionary repair driven sales.

Key Detractors

Allkem (AKE, underweight) – our underweight position in the lithium producer was a portfolio detractor during the quarter. Lithium carbonate prices rallied from recent lows across the period to end the quarter up 24% at US$41k/t. In addition, AKE announced plans to merge with peer Livent Corporation (LTHM.US), with the merger ratio implying a 7% premium for AKE shareholders. Our preference amongst lithium exposures remains IGO. While we recognize Allkem offers lithium supply diversity across both brine (Olaroz) and hard-rock (Mt Cattlin) operations, we are concerned with its material asset-specific and geopolitical risks.

WiseTech (WTC, underweight) – our underweight position in the logistics industry software solutions provider was a source of underperformance during the period, with WTC benefiting from a rotation into those software names that might benefit from AI developments. We believe WTC is continuing to build an exceptional product in CargoWise which should continue to attract and retain large and key freight forwarders. Despite WTC's high-quality earnings growth, we struggle to justify paying 80-times earnings given the more attractive opportunities available in the sector (e.g. XRO).

EBOS (EBO, overweight) – the pharmaceutical distributor underperformed during the period after losing the Chemist Warehouse distribution contract. We have a positive view toward the company with defensive earnings growth across both health care and animal care divisions, with both businesses having no other recontracting risk similar to Chemist Warehouse. Furthermore, both divisions have opportunities to supplement organic growth via acquisitions with the company having a strong track record of identifying suitable targets and integrating them successfully.

Link Group (LNK, overweight) – the diversified superannuation administration provider underperformed over the period following an adverse update in late June specific to its Retirement & Superannuation Solutions (RSS) business which confirmed that a superannuation customer representing approximately 4% of the business' revenue would not be renewing their contract in FY25. Notwithstanding LNK calling out that FY23 was overall tracking ahead of expectations, the share price weakened as investors queried if LNK may need to trade off margin for renewal certainty in future years.

oOh! Media (OML, overweight) – the outdoor advertising company underperformed during the period given short term cyclical headwinds to revenue and higher-than-expected costs on contract renewals. We continue to hold an overweight position in OML given cyclical media market upside in the medium term, and expectations that the outdoor media category will expand its share of traditional advertising (digital product / improved audience measurement). We expect OML's cost growth will be limited with high fixed cost leverage, while the company is improving its market share of the outdoor category, and the balance sheet remains in a strong position.

Key Purchases

Region (RGN) – we initiated a position in the suburban shopping mall owning REIT in the period. We believe RGN's retail asset base, which comprises 96 predominantly neighbourhood shopping centres, will prove to be resilient during the consumer downturn. This is supported by its high skew to supermarket/anchor tenant income (46% total Net Operating Income), affordable specialty rents (8.7% average occupancy cost) and high overall portfolio occupancy (98%). The stock valuation is attractive, at 0.86-times net asset backing and offering a dividend yield above 6%.

Vicinity Centre (VCX) – we initiated a position in the shopping mall owning REIT in the period. Key supportive factors include VCX's asset mix, with over half its asset base exposed to more advantaged segments of retailing (i.e. luxury, DFO outlets in recovering CBDs), more resilient in-place leases with high occupancy and fewer holdovers. Further, VCX has a strong balance sheet (gearing 25.7% as at Dec-22) and attractive valuation, with the stock trading at 0.80-times net asset backing and offering a dividend yield above 6%.

Netwealth (NWL) – the portfolio increased its position in the leading independent wealth management platform provider during the quarter. NWL is set to continue its strong revenue growth for the foreseeable future and capture an outsized level of funds under administration as Australia's wealth management industry fragments away from the historically dominant players. In our view, NWL's valuation of 24-times FY24 EV/EBITDA does not adequately capture its long-term growth opportunity, high incremental margins and strong cash flow generation.

Key Sales

OZ Minerals (OZL) – we exited our position in the copper producer during the quarter following the completion of the $28.25/share all-cash takeover from diversified miner BHP.

The Lottery Corporation (TLC) – we divested our position in the lotteries business since it now sits outside the portfolio's mandate. We continue to hold a favourable view of TCL, noting that while jackpot sequences are largely luck dependant and vary week-to-week, they will normalise over time with limited implications for our long-term view. With cash generative assets underpinned by long-dated licenses, we view TLC as an attractive blend of growth and yield at a reasonable asking price for what we view as a high-quality business (16.0 times EV/EBITDA, 3.5% dividend yield).

Nanosonics (NAN) – we reduced our position in the disinfection medical device company following significant outperformance in prior months, but remain positive on the long-term growth opportunity given the company's position as the global market leader in probe disinfection. We expect strong organic sales growth will be driven by adoption of the product in existing markets such as the US and Europe and expansion into new markets such as Japan and China. Furthermore, revenue growth is also supported by the upgrade cycle for the next generation Trophon product and a strong pipeline of new product activity which is underpinned by significant R&D investment.

Key Active Overweights

Reliance Worldwide (RWC) – the market is showing elevated concern for a weaker demand environment for the manufacturer and distributor of plumbing and heating parts, with RWC's FY23 earnings estimates now lowered following recent market updates. We view RWC as a compelling opportunity; while the market is pricing for a significant decline in earnings (P/E of only 14.2-times vs 17.0 times mid-cycle), we remain constructive on the demand environment given the defensive nature of its revenue base, the majority of which relates to non-discretionary repair activity.

NEXTDC (NXT) – the portfolio holds an overweight position in the data centre provider, which we view as holding a leading position in the domestic data centre market and with a proven ability to deploy capital into its data centres at attractive returns. NXT's recent and very large 36MW increase in contracted capacity demonstrates the continued structural growth of demand for data centre capacity in the Australian market, mirroring global trends. We regard NXT's current 29.0times FY25 EV/EBITDA multiple as attractive given these trends.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following COVID-19 impacts across FY20-22. Revenue is expected to grow 13-15% in FY23, with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) and structural drivers (capital investment required to decarbonise) pointing to strong top-line growth ahead. Margins are also set to accelerate over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

Iluka Resources (ILU) – we remain overweight the mineral sands producer, reflecting our view of the solid structural support for key mineral sands commodities (zircon and titanium dioxide) as demand improves and existing mine supplies decrease. Currently the world's largest zircon producer and the fifth largest producer of titanium feedstocks, ILU is moving into Rare Earths production through the Eneabba refinery (currently under development in Western Australia). Rare Earths are a by-product of mineral sands mining and a key component of permanent magnets that are critical to electric motors, including those in electric vehicles and wind turbines. With 90% of the world's Rare Earths currently produced in China, we see significant strategic value in this part of ILU's business.

Netwealth (NWL) – the portfolio maintains an overweight position in the leading independent wealth management platform. NWL is set to continue strong revenue growth for the foreseeable future as the company captures an outsized level of funds under administration as Australia's wealth management industry fragments away from the historically dominant players. In our view, NWL's 25.0 times FY24 EV/EBITDA multiple does not capture its long-term growth opportunity, high incremental margins, conservative accounting and strong cash flow generation.

Key Active Underweights

WiseTech (WTC) – we remain underweight the logistics industry software solutions provider, with a preference for other names in the technology sector given WTC's demanding valuation of 80.0-times 1-year forward P/E. We believe WTC is continuing to build an exceptional product in CargoWise which should continue to attract and retain large and key freight forwarders. Despite WTC's high-quality earnings growth, we struggle to justify paying such a demanding multiple given the more attractive opportunities available in the sector (e.g. XRO).

Allkem (AKE) – we remain underweight the lithium producer, instead retaining a preference for lithium exposure via IGO. While we recognize Allkem offers lithium supply diversity across both brine (Olaroz) and hard-rock (Mt Cattlin) operations, we remain concerned by asset-specific risks. Olaroz has faced significant operating challenges associated with chemical processing at altitude, while hyperinflation challenges in Argentina present a macro risk overlay. Mt Cattlin is a smaller and higher cost spodumene mine than IGO's Greenbushes operations. The proposed merger with Livent Corporation (LTHM.US) offers increased vertical integration, but further focuses AKE in South America.

Washington H Soul Pattinson (SOL) – we do not hold a position in the diversified investment company. At this time, we see better direct investment opportunities available than those offered through SOL's broad suite of investments across the telco, mining, manufacturing, healthcare, and funds management sectors. We also remain cautious on the long-term sustainability of earnings from the company's exposure to coal via its ~38% stake in coal miner New Hope (NHC).

Atlas Arteria (ALX) – we remain underweight the developer and operator of toll roads, with the stock trading close to an enterprise value equivalent to where it was trading before undertaking its value destructive acquisition of the Chicago Skyway toll road. In recent months, the outlook for all three of ALX's major assets has deteriorated, leading to a permanent downgrade in our view of portfolio quality. We now believe that ALX's major asset, the APRR concession, will ultimately go through a re-tender process and that the restructure of Dulles Greenway will require considerable additional equity (instead of releasing equity).

REA Group (REA) – we hold an underweight position to Australia's largest online residential real estate platform business, and instead gain indirect preferred exposure to the online real estate segment via Domain Holdings (DHG) through the portfolios position in Nine Entertainment (NEC) (which owns 60% of DHG). We see the valuation of REA as unattractive trading on 41.0-times P/E, and see superior risk adjusted returns in other high-growth online businesses such as Carsales.com (CAR) which trades on 28.0-times P/E.

Market outlook

We have been of the view that the June quarter 2023 will mark the top of the interest cycle for most of the developed world, however, global central banks are seemingly prepared to continue hiking interest rates despite evidence inflation is moderating, lending availability tightening and economic growth faltering. With respect to the latter, we have received confirmation that the Euro Area entered recession and the Federal Reserve staff have retained their forecast that a modest recession in the US is likely. Nevertheless, it seems the appetite for policy makers to persist with the tightening cycle into Q3 has remained, with central bankers seemingly perplexed at why services inflation has yet to ease and why the labour market has yet to ease appreciably. It is possible that a pause in the hiking cycle in June by the Fed will set the scene for a pause across most of the developed world, however, the risk of overtightening and even weaker economic activity is now a real prospect. We believe the US labour market is set to post more modest employment gains from mid-23 which in concert with improving labour supply will continue to moderate wage growth and help underwrite the commencement of a gradual easing cycle in the US by the end of 2023. However, we have to acknowledge that the message from most central banks is that further hikes may be required and an interest rate easing cycle is not in prospect.

This weak economic growth narrative in concert with enthusiasm over the potential impacts from AI has seen large cap 'growth' stocks drive a narrow but strong equity market rally. This has largely hidden from view an ongoing negative earnings revision cycle which in concert with rising bond yields is leaving aggregate market valuations looking more challenging.

Economic growth has also slowed in Australia, recording just 0.3%qoq growth in the March quarter and much of this growth can merely be traced to strong population growth and ongoing engineering construction projects. It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. Nominal retail sales have slowed to 0% six -month annualised, following on from declining volumes in recent quarters. Building approvals continue to decline and are likely to decline further in coming months as declining housing affordability outweighs the impact of an under supplied housing market. Moreover, it is also clear that despite the Federal Budget forecast to return to surplus, that government demand growth is waning even faster than private demand growth.

Nevertheless, after describing the May decision to increase interest rates as finally balanced, the Reserve Bank of

Australia (RBA) followed up with a further hike in June and a pause in July, but has flagged that further tightening may be required. The RBA has clearly shifted its focus to worrying about weak productivity growth and high unit labour costs as the main reason for fearing inflation may be higher than it forecasts. We think this ignores the fact that average compensation per hour has not risen sharply, and the main reason for high unit labour costs is a surge in hours worked and employment as the influx in immigration is absorbed into a slowing economy. While this shift in the RBA's focus risks a further hike in August, in our view the RBA would have been better served to pause after the May rate hike, rather than risking a harder economic landing.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be for nominal GDP growth will slow quickly over the next 6 months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted households exposed. As such we remain particularly cautious on discretionary retail spending.
3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A$10bn export industry for Australia and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's 2nd largest copper resource. LNG is an important energy transition fuel, and currently accounts for 23% of global electricity generation. Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations, we believe financial conditions are now firmly in the restrictive zone. From our perspective, the RBA's focus on global growth, trends in household spending and the outlook for inflation and labour markets in informing their future decisions suggest that multiple additional hikes are unlikely to be required. While interest rate hikes in Australia will remain a month-to-month proposition for the next six months, our bias is that the RBA should have concluded its hiking cycle, yet an ever-shifting RBA framework suggest they may hike again in August. It is unlikely that policy easing will be delivered in 2023, however, we do expect that the RBA will commence a modest easing cycle in 1H24.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. However, the RBA has recently sounded more hawkish than the Fed the A$ has started to appreciate. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US$ down trend will persist as the Fed pivots from its hiking strategy to an easing cycle in 2023, we expect the A$/US$ will appreciate to the mid70s towards the end of 2023.

We are most overweight stocks within the Communication Services, Health Care and Industrials sectors, and are underweight Energy, Real Estate and Consumer Discretionary.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.84	6.14	5.70
Consumer Discretionary	8.03	10.67	-2.64
Consumer Staples	1.19	3.54	-2.35
Energy	0.00	5.36	-5.36
Financials	12.78	12.46	0.32
Health Care	8.79	5.20	3.59
Industrials	15.26	13.47	1.79
Information Technology	10.28	8.75	1.53
Materials	21.52	23.24	-1.71
Real Estate	6.90	9.94	-3.04
Utilities	0.00	1.23	-1.23

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Reliance Worldwide	4.96	0.62	4.34
NEXTDC	4.93	1.23	3.70
Carsales.com	4.86	1.71	3.15
Worley	4.50	1.12	3.38
Iluka	4.20	0.90	3.30

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	4.96	0.62	4.34
NEXTDC	4.93	1.23	3.70
Worley	4.50	1.12	3.38
Underweights			
Wisetech Global	0.00	2.67	-2.67
Allkem	0.00	1.83	-1.83
Washington H. Soul Pattinson	0.00	1.48	-1.48

Portfolio holdings may not be representative of current or future investments. The securities discussed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.

Income and growth

	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.
Growth return	11.26	3.12	1.89	6.71
Distribution return	7.47	7.58	5.09	3.73

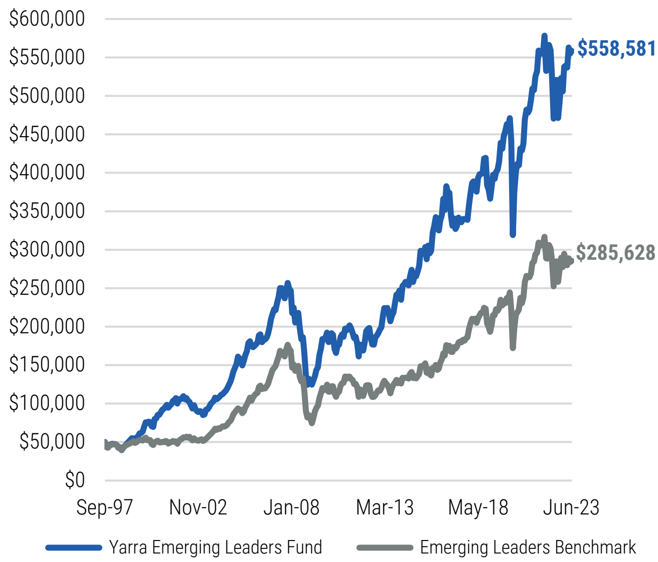
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders by way of income distribution in a 12-month period. It does not include capital distributions.

Features

Investment objective	To achieve medium-to-long term capital growth through exposure to small and medium sized Australian companies that are considered to possess strong capital growth potential. In doing so, the aim is to outperform the benchmark over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	September 1997	
Fund size	A$89.4 mn as at 30 June 2023	
APIR codes	JBW0010AU	
Estimated management cost	1.25% p.a.	
Buy/sell spread	+/- 0.20%	
Platform availability	Asgard Ausmaq BT Panorama BT SuperWrap Financial Index	Hub24 Macquarie Wrap Mason Stevens MLC Wrap OneVue

Investment performance comparison of $50,000

After fees, since inception of the Yarra Emerging Leaders Fund, September 1997 to June 2023.



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Applications and contacts

Investment into the Yarra Emerging Leaders Fund can be made by Australian resident investors only.

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